[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED ESTATE AND GIFT TAX TREATY BETWEEN THE UNITED STATES AND FRANCE

PREPARED FOR THE USE OF THE

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INTRODUCTION

This pamphlet provides an explanation of the proposed estate and gift tax treaty between the United States and the French Republic ("France"). The proposed treaty was signed by the United States and France on November 24, 1978 and has been submitted to the Senate for advice and consent to its ratification. A public hearing on the proposed treaty is scheduled for June 6, 1979, by the Senate Committee on Foreign Relations.

The portion of the proposed treaty dealing with estate taxation will replace the existing estate tax treaty and protocol between the United States and France, which have been in force since October 17, 1949. There is no existing gift tax between the two countries.

The first part of the pamphlet is a summary of the principal provisions of the proposed estate, inheritance and gift tax treaty. This is followed by a detailed, article-by-article explanation of the treaty.

I. SUMMARY

The basic thrust of the proposed estate and gift tax treaty between the United States and France is to alleviate double taxation on estates and gifts of French and U.S. domiciliaries and U.S. citizens by modifying the jurisdictional rules of estate and gift taxation with respect to these individuals. The treaty modifies these rules in two ways. First, the countries agree that an individual's country of domicile has primary tax jurisdiction on the estates and gifts of its domiciliaries. However, real property, assets of a permanent establishment or fixed base, and tangible personal property which are located in the other country ("situs country") are subject to primary tax jurisdiction in the situs country.

The second modification occurs in situations where, under the laws of each country, an individual is considered to be a domiciliary of both countries. In such circumstances, the countries agree to treat the individual as having only one country of domicile for purposes of the taxes covered by the treaty. The treaty sets forth several criteria for purposes of determining which country is the country of domicile.

Estate and gift taxation

The United States imposes its estate tax on estates of individuals who were U.S. citizens or U.S. domiciliaries at the time of their death, and on assets of nondomiciliaries where the assets are situated in the United States at the time of their death. The United States imposes its gift tax on gifts made by U.S. citizens and U.S. domiciliaries regardless of where the property which is the subject of the gift is located, and also on gifts made by nondomiciliares where the property which is the subject of the gift is tangible property situated in the United States at the time of the gift.

France imposes its succession duty on estates of individuals who were domiciled in France at the time of their death, or on the assets of persons not domiciled in France where the assets were situated in France at the time of their death. The French gift duty is imposed on gifts made by persons who were domiciled in France at the time the gift was made, and on gifts made by persons not domiciled in France where the property was situated in France at the time of the gift.

Causes of double taxation

It is taxation on worldwide assets that creates the potential for double taxation. Double taxation usually occurs in situations where a decedent was either domiciled in both countries or was domiciled in one country and owned property located in another country.

Since each country has its own definition of what consitutes domicile in that country, it is possible that the definition of domicile in the two countries could overlap and a person could thus be considered a domiciliary of both countries. As such, his estate would be subject to worldwide taxation by both countries.

When the decedent is domiciled in only one country but owns property in the other country at the time of his death, such property is subject to tax in the situs country regardless of the decedent's domicile. Thus, the country of domicile will tax the property, since it is included in the worldwide assets of the estate, and the situs country will tax the property because it was located within its boundaries at the time of the decedent's death.

In both of these situations, unless one of the two countries gives up its right to tax the property or allows a credit for the estate taxes paid to the other country, the estate will be subject to double taxation.

A similar situation exists for gifts where the donor is a domiciliary of both countries or where the donor is a domiciliary of one country and the property which is the subject of the gift is situated in another country. As in the case of estates, the country of domicile will tax the gifts made by its domiciliaries on a worldwide basis, and the situs country will tax those same gifts to the extent the property is located within its boundaries. Again, unless one of the countries gives up its right to tax the transfer or allows a credit for the taxes paid to the other country, the gift will be subject to double taxation.

Elimination of double taxation

The proposed treaty will alleviate double taxation on gifts and estates of United States citizens and domiciliaries and French domiciliaries in some situations by allowing only one country to impose its tax and in others by allowing both countries to impose a tax but requiring one of the countries to allow a credit against its tax for the taxes paid to the other country.

In most situations, the treaty allows the country of domicile to assert primary tax jurisdiction. However, the situs country is given priority taxation in the case of real property, tangible personal property, and business assets which are located in that country.

The treaty provides that the domicile of an individual will be determined separately under the laws of each country. If only one of the two countries treats the individual as a domiciliary under its domestic laws, then that is the country of domicile for purposes of the treaty. However, if both countries treat the individual as a domiciliary under their domestic laws, then the treaty sets forth an extensive set of rules to determine the individual's domicile for purposes of establishing primary tax jurisdiction under the treaty. The approach used in this set of rules is to recognize that where an individual domiciled in both countries is a national of one of the two countries and has been resident for only a limited period of time in the other country, his ties with the country of residence are not sufficient to justify the assertion of primary tax jurisdiction by that country. However, where an individual has been domiciled in both countries for a substantial period of time, the country with which he has his closest ties (such as the place of his permanent home) has the greater claim to domicile and, thus, primary tax jurisdiction will generally be allowed to that country.

II. EXPLANATION OF PROPOSED TAX TREATY

A detailed explanation of the proposed treaty on an article-by-article basis is presented below.

Article 1. Estates and gifts covered

The proposed treaty applies to estates of decedents who were domiciled in France at the time of their death and to estates that are subject to tax in the United States because the decedent was a citizen or domiciliary of the United States at the time of his death. With respect to gifts, the treaty applies to gifts made while the donor was a domiciliary of France and to gifts which are subject to tax in the United States because the donor was a citizen or domiciliary of the United States when the gift was made. Generation-skipping transfers which are subject to tax in the United States because the transferor was a U.S. citizen or domiciliary are also covered.

The proposed treaty does not treat certain residents of U.S. possessions as U.S. citizens or domiciliaries. These are individuals who acquired U.S. citizenship solely because they were citizens of a possession or because they were born in a possession or were residents of a possession. Under U.S. law (Code sec. 2209 and sec. 2501(c)), these individuals are not taxed by the United States on their worldwide estates and gifts, so protection against double taxation is generally unnecessary. Accordingly, the proposed treaty will not apply to estates or gifts of these individuals, unless it is applicable by reason of their being domiciled in France.

Article 2. Taxes covered

The proposed treaty applies to the U.S. estate tax, gift tax, and the tax on generation-skipping transfers.

The United States imposes its estate tax on the worldwide assets of estates of persons who were citizens or domiciliaries of the United States at the time of their death, and on property belonging to nondomiciliaries of the United States which is located in the United States at the time of their death. The U.S. gift tax is imposed on all gifts made by U.S. citizens and domiciliaries, and on gifts of property made by nondomiciliaries where the property is tangible property located in the United States at the time of the gift.

The U.S. tax on generation-skipping transfers was enacted in 1976 to prevent the transfer of the use of property among generations of the transferor's descendents without the payment of gift or estate taxes. In general, the tax on such transfers is imposed when property passes through a trust from persons of one generation to persons of another generation, and the transfer is not otherwise subject to estate or gift tax.

The proposed treaty applies to the French succession duty and the French gift duty. The succession duty is imposed on the world-wide assets of persons domiciled in France at the time of their death, and

on property of nondomiciliaries of France where the property is located in France at the time of their death. France imposes a gift duty on all gifts made by persons domiciled in France, and on property of nondomiciliaries that is located in France at the time of the gift.

As is generally true in the case of other U.S. estate tax treaties, the proposed treaty does not apply to death or gift taxes imposed by state or local governments. In addition, the proposed treaty provides that it will apply to any substantially similar taxes on estates, inheritances and gifts that either country may subsequently impose. The competent authorities of both countries are required to notify each other in the case of any substantial changes in their estate, inheritance or gift tax laws.

Article 3. General definitions

The standard definitions generally found in most existing U.S. estate tax treaties are contained in the proposed treaty.

The United States is defined to mean the fifty states and the District of Columbia. Thus, U.S. possessions and territories are not covered by the treaty. France is defined to mean that part of France situated in Europe and the Overseas departments of the French Republic which include Guadaloupe, Martinique, Guiana and Reunion. The geographical definition of both countries also includes any area where either country may, under international law, exercise rights with respect to the natural resources of the seabed and sub-soil.

The proposed treaty also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country whose tax is being determined. In addition, it is further provided that where a term is defined in a different manner by the two countries, the countries may establish a common meaning of the term in order to prevent double taxation or to further any other purposes of the proposed convention.

Article 4. Fiscal domicile

The concept of domicile is important under the proposed treaty because the country of domicile has, under the treaty, primary tax jurisdiction on all property other than the property subject to situs taxation. The country of domicile is initially governed by the domestic laws of each country. However, in those situations where both countries would treat an individual as a domiciliary, the treaty sets forth rules for establishing the country of domicile for purposes of the taxes covered by this treaty.

However, the tests employed by countries to determine the domicile of an individual often are quite different. Under the Internal Revenue Code an individual is considered a domiciliary of the United States for purposes of the Federal estate and gift tax if the person was residing in the United States and had the intent to remain in the United States indefinitely (or had been residing in the United States with such an intent and had subsequently left this country without an intent to remain indefinitely at his new place of residence). A person is considered domiciled in France if his main establishment is in France. In general, a person's main establishment is where he physically resides and intends to live permanently.

To provide relief from double taxation where the individual is considered domiciled in both countries under their domestic laws, the proposed treaty provides a series of rules designed to establish a single country of domicile for the individual for purposes of the taxes covered by the treaty. The country so selected will then have the primary tax jurisdiction with respect to the worldwide estate of the decedent or his worldwide gifts, other than with respect to real property, business assets or tangible property situated in the other country. As described below, these rules are based on the concept that primary tax jurisdiction should be exercised either by the country of nationality, if the dual domicile individual has not been resident in the other country for a substantial period of time prior to his death or the making of the gift, or by the country in which he has his most significant contacts if that nationality test is not determinative.

In determining the domicile of an individual under the proposed treaty, each country will first determine whether the individual is considered a domiciliary under its law. If the individual is a domiciliary of only one country then that will be the individual's country of domicile for purposes of the proposed treaty. However, if the person is determined to be a domiciliary of both countries the proposed treaty provides a series of rules by which an exclusive domicile for the individual will be determined.

The first rule that is applied consists of two separate tests which apply to persons who are citizens of only one of the two countries. Under the first test, such a person will be considered domiciled in the country of which he is a citizen if he was domiciled in the other country for less than 5 years during the 7-year period which ends with the year of his death or the year the gift was made, and he was in that country because of an assignment of employment or because he was the spouse or dependent of a person who was in that country for such a purpose. Under the second test, the person will be considered a domiciliary of the country of which he is a citizen if he was domiciled in the other country for less than 7 years during the 10-year period which ends with the year of his death or the year the gift was made, and he was in that country because of a renewal of an assignment of employment or because he was the spouse or dependent of a person who was in that country for such a purpose.

A second rule, which is similar to the first in that it applies to persons who are domiciliaries of both countries and citizens of only one of the countries, applies if domicile cannot be resolved under the first rule. Under the second rule such a person will be considered a domiciliary of the country of which he is a citizen if he had a clear intention to retain his domicile in that country and he was domiciled in the other country for less than 5 years during the 7-year period which ends with the year of death or the year the gift was made.

It is contemplated that these rules will resolve the great majority of dual domicile situations. However, if a dual domicile problem still remains after application of these rules, the proposed treaty provides four additional rules to determine domicile. The rules (applied in the order presented) provide that the individual will be considered domiciled in the country (1) in which he maintained his permanent home, (2) in which his personal relations were the closest

(center of vital interests), (3) in which he had a habitual abode, or (4) in his country of citizenship. In cases where an individual's domicile cannot be determined under these rules, the competent authorities of the countries are to settle the question by mutual agreement.

Article 5. Immovable (real) property

Under the proposed treaty, immovable (real) property is one of the three types of property over which the situs country has primary tax jurisdiction rather than the country of domicile. The other two are assets of a permanent establishment or fixed base (*Article 6*) and tangible movable property (*Article 7*).

The determination of whether an item of property is immovable (real) property is to be made under tax the laws of the country in which the property is located. Although U.S. law does not define "immovable (real) property," that term for U.S. purposes is considered to mean real property. It is further provided that immovable (real) property does not include claims secured by real property (such as mortgages). Real property which is part of the business assets of a permanent establishment or used for the performance of professional or similar independent services is taxable under this Article, rather than *Article 6*.

Article 6. Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of professional services

Under the proposed treaty, the second type of property over which the situs country has primary tax jurisdiction is the business assets (other than real property) of an individual's permanent establishment which are located in the situs country (other than ships and aircraft operated in international traffic and related personal property) and the assets (other than real property) of a fixed base of such person which is situated in the country and is used for the performance of professional services or other similar independent activities. The real property of either enterprise is to be taxed by the country in which it is situated, as provided in *Article 5*.

The proposed treaty contains a definition of the term "permanent establishment" which is similar to the definition found in recent U.S. income tax treaties. Generally, any fixed place of business through which a person engages in a trade or business is considered a permanent establishment. For this purpose, a person is considered engaged in a trade or business regardless of whether the business is carried on as a sole proprietorship or through a partnership or as an unincorporated association which is not taxed as a corporation. In the case of a partnership or association, however, only the person's interest in the business entity will be taken into account for purposes of this provision.

A fixed place of business generally includes a branch, office, factory, workshop, warehouse, place of extraction of natural resources, outlet, and any building site or construction or assembly project which exists for more than 12 months. This general rule is modified by providing that a fixed place of business which is used for certain activities specified in the treaty will not be considered a permanent establishment. These activities include, for example, the warehousing of goods for purposes of storage, display, delivery, or processing by another person,

and the use of a fixed place of business solely for the purpose of purchasing merchandise or collecting information. An additional activity included within this exempt category is the maintenance of a fixed place of business solely for investment purposes of an individual, whether conducted by the individual, his employees, a broker or other agent.

The proposed treaty also provides that a person will be deemed to have a permanent establishment in a country if he had an agent in that country who had and habitually exercised a general contracting authority (other than for the purchase of goods or merchandise) in that country. This agency rule does not apply, however, if the agent is a broker, general commission agent, or any other agent of an independent status, provided the agent is acting in the ordinary course of his business.

A company will not be held to have a permanent establishment in one of the countries solely because it controls a company which is a resident of that country.

Article 7. Tangible movable property

With three exceptions, tangible movable (i.e., personal) property, other than currency, is subject to tax in the country in which the property is situated. The first exception is for property which is subject to tax in the other country under the rules previously discussed in *Article 6* concerning permanent establishments and a fixed base used for the performance of professional services. This property is subject to tax by the country in which the permanent establishment or fixed base is located.

A second exception is for property owned by an individual, who is considered domiciled in the country of which he is a citizen (under the special 5-of-7 or 7-of-10 year rules used in *Article 4(3)* to determine domicile) if the property is for the normal personal use of such person or his family. Essentially, this property can only be taxed by the country of citizenship.

Finally, ships and aircraft operated in international traffic, and personal property pertaining to the operation of such ships and aircraft, may be taxed by the country in which they are registered. Other ships and aircraft may be taxed by the country whose harbors and airports are most frequently used by the ships and aircraft.

Article 8. Taxation other than pursuant to Articles 5, 6, and 7

This article sets forth the general treaty rule that the country of domicile, as determined under the treaty, has the primary tax jurisdiction over the estates or gifts of its domiciliaries other than the property specifically reserved for situs taxation.

The proposed treaty provides that property, other than real property, assets of a permanent establishment or fixed base, and tangible personal property, may be subject to tax in either of the two countries only if the individual is a citizen or domiciliary of that country and such property is otherwise subject to tax in that country. This provision is explicitly extended to cover corporate stock, debt obligations, intangible property and currency.

Since the United States does tax based upon citizenship (France does not), there is still the possibility of double taxation if an individual is a U.S. citizen and a French domiciliary. The possibility of

double taxation in that situation is, however, alleviated under the tax credit structure established in *Article 12.*

Article 9. Deduction of debts

The proposed treaty provides that if debts are deductible from the value of property in computing the estate or gift tax of either country, these debts are to be deducted from the gross value of the property subject to tax in that country in the same proportion that such gross value bears to the total gross value of all the property. However, in computing the French tax, debts pertaining to a permanent establishment or a fixed base are to be deducted in total from the assets (other than real property) that relate to the permanent establishment or fixed base. Similarly, debts relating to ships and aircraft, and their movable property, are to be deducted in total from the value of those assets. These debts are to be allowed as a deduction in computing the French tax under the treaty even if they would not be allowed as a deduction under French internal law.

Article 10. Charitable exemptions and deductions

Essentially, this provision allows contributions made to charitable organizations in one country to be exempt from tax in the other country or to be deductible in computing the tax in that other country. This treatment is allowed only if the transfer would be eligible for an exemption or deduction if the charitable organization had been created in the taxing country. Additionally, the charitable organization must have a tax-exempt status in its home country so that payments to it are exempt or fully deductible, it must be organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, and it must receive a substantial part of its support from public or governmental funds. Thus, in computing the French tax, no deduction or exemption is allowed for contributions to a private foundation, even if the contribution would be deductible under U.S. law.

Contributions to governmental organizations will not qualify for exempt or deductible status unless the contribution is specifically limited to one of the tax-exempt purposes enumerated above.

Article 11. Community property and marital deduction

The proposed treaty allows U.S. citizens and domiciliaries to elect to treat property which is subject to the French tax as being community property. Essentially, this means that France will only tax one-half of the gifts made by a person to his spouse and it will only tax one-half of the property that passes from a decedent to his spouse. In both cases, the other one-half is deemed to already belong to the spouse under the elected community property laws.

Reciprocally, French domiciliaries may, in computing their U.S. tax, take the marital deduction that would be allowed to a U.S. domiciliary on November 24, 1978, the date the proposed treaty was signed. Currently, a nondomiciliary does not get a marital deduction. Under this provision, the taxpayer will also be allowed to use the tax rates in effect at the time of the transfer.

If the laws of either country are modified substantially to reduce the benefits available under this provision, the tax authorities of the two

countries will consult on whether this provision should be modified or terminated. Actual modification or termination will require action under the termination provision (*Article 20*) or otherwise in accord with the constitutional procedures of each country.

Article 12. Exemptions and credits

Except as otherwise provided in the treaty, each country shall compute its estate or gift tax in accordance with its own laws including the allowance of exemptions, deductions, credits, and other allowances allowed under the country's internal law. In general, double taxation is avoided because France exempts property from taxation that is subject to situs taxation by the United States and because the United States allows a credit for taxes paid to France on property subject to situs taxation in France.

Specifically, real property, assets of a permanent establishment or fixed base, and tangible movable property, which are subject to situs taxation in the United States, as provided for in the proposed treaty, will be completely exempt from tax in France. However, this property will be taken into account in determining the appropriate tax rate applicable to the property which is subject to French taxation (i.e., an exemption with progression).

Correspondingly, the United States will allow a credit against its estate or gift tax for taxes paid to France on property where, under the proposed treaty, the property is subject to situs taxation in France. However, the credit will only be allowed for taxes actually paid to France and the credit is not to exceed the U.S. estate or gift tax attributable to the property. In addition, such credit is in lieu of any other such credits allowed under the laws of the United States.

The United States gives France primary tax jurisdiction over U.S. citizens determined to be French domiciliaries under the treaty. The treaty provides that the United States will give a full tax credit for taxes paid to France by a U.S. citizen who is deemed to be a French domiciliary under the treaty (i.e. the amount of the credit can exceed the amount of the U.S. tax attributable to the property). However, if the U.S. tax exceeds the French tax, the excess will be collected by the United States.

The proposed treaty stipulates that the treaty will not increase the amount of tax due to either country under its domestic laws. However, a reduction in the amount of the foreign tax credit allowed by the Unted States against its estate and gift tax will not be considered to be an increase in tax. This prevents the argument that an individual would have received a higher foreign tax credit without the treaty, because he would have paid more French taxes, and thus should be allowed the higher foreign tax credit even though the treaty reduced his French tax.

Article 13. Time limitations on claims for credit or refund

Under the Internal Revenue Code, a claim for credit or refund of U.S. estate and gift taxes generally must be made within 3 years from the date the return was filed. The proposed treaty provides a period of limitation during which claims for credit or refund of taxes based on the provisions of the treaty may be made which, in some cases, may be longer than that allowed by the Internal Revenue Code. It is provided

that a claim for a credit or refund of taxes based on the provisions of the treaty must be made before the expiration of the latest of (1) the period of limitations prescribed under the domestic law of the country to which the claim is made, (2) 5 years from the date of the decedent's death or the date of the gift, or (3) 1 year after final determination and payment of a tax for which a credit is claimed under the treaty (provided these events occur within 10 years from the date of the decedent's death or the date of the gift).

The proposed treaty follows the approach of other U.S. estate tax treaties and provides that any refund based on the provisions of the treaty is to be made without interest.

Articles 14 and 15. Administrative provisions

The proposed treaty contains various administrative provisions which are generally found in other U.S. tax treaties. In general, the proposed treaty provides—

(1) For consultation and negotiation between the competent authorities of the two countries to resolve differences arising in the interpretation or application of the proposed treaty and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the proposed treaty;

(2) For the exchange between the countries of information pertinent to carrying out the provisions of the proposed treaty or the tax laws of one of the countries, insofar as its taxation is in accordance with the proposed treaty, or to prevent fraud or fiscal evasion with respect to the taxes covered by the proposed treaty; and

(3) For continuing the tax return and recordkeeping requirements that exist under each countries' domestic law, except with respect to U.S. provisions which the Treasury finds are not necessary for the prevention of fraud or fiscal evasion.

Article 16. Assistance in collection

The two countries agree to assist each other in collecting each other's estate and gift taxes. This assistance extends to enforcing assessments that have been finally determined under the law of the requesting country and taking measures of conservancy where the assessment has not been finally determined. The assistance each country is obligated to give is limited to the enforcement measures it can take in enforcing its own assessments.

The assistance provided by a country will not extend to enforcement of assessments against estates of its own citizens.

Article 17. Diplomatic and consular officials

The proposed treaty provides that its provisions are not to affect the fiscal privileges which diplomatic and consular officials and officials of international organizations enjoy under the general rules of international law or the provisions of special agreements. It is further provided that the right to tax those persons will be reserved to the country for whom they perform their functions and that these officials are not to be considered domiciled in the country where they are employed (the receiving country). This provision is designed to prevent diplomatic and consular officials of a third country from claiming

domicile in either the United States or France so as to bring themselves within the provisions of the convention.

Article 18. Territorial extension

The proposed treaty contains a method similar to that found in some of our other U.S. tax treaties by which the treaty may be extended to any of the Overseas Territories of the French Republic or to any territories for whose international relations the United States is responsible, if the territory imposes taxes substantially similar to those covered by the treaty. The treaty may be extended pursuant to this provision either in its entirety or with necessary modifications. The extension is to be effected in accordance with the constitutional procedures of the two countries. This requirement follows the Senate's reservation to the territorial extension provision of the income tax treaty between the United States and France.

Any extension of the treaty to an eligible territory of either country may be terminated after one year. Additionally, if the treaty between the two countries is terminated, the termination shall extend to any extensions made under the treaty.

Article 19. Entry into force

The proposed treaty will enter into force on the first day of the second month following the month in which the instruments of ratification are exchanged and will apply to estates of persons dying and to gifts made on or after that date. The existing treaty terminates at that time.

Article 20. Termination

The proposed treaty will continue in force indefinitely but either country may terminate it as of the close of any calendar year which ends at least 5 years after the treaty enters into force. Termination is accomplished by delivering written notice between January 1st and June 30th of that same year.

The proposed treaty can also be terminated if changes in the tax laws of either country result in a substantial alteration of the effects of the treaty. Such termination will occur 6 months after the delivery of notice. A termination under this provision is not subject to the 5-year minimum period previously mentioned.

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